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VOL. CLIII NO. 92 Wednesday, May 11, 1988

Today

Fifteen of the top 25 bank holding companies are now superregionals, making the newest category of holding company the norm rather than the exception. As a result of mergers, two new banking firms enter this top grouping: Shawmut National Corp., Hartford, Conn., and First Fidelity Bancorp., Newark, N.J. 2

Poor management and the failure of Colorado's Division of Banking to enforce regulations played a significant role in the state's industrial bank crisis, according to the state auditor. 2

National banks can now purchase stock in the Federal Agricultural Mortgage Corp., or Farmer Mac, the Comptroller's office has ruled. 14

Executive Changes 5
In the News 3

COMMENT

The leveraged buyout market is strong, but a number of pitfalls can hamper the unwary banker, according to Nora Ann Wallace. 4

TECHNOLOGY

Profit margins on check clearing services have declined over the past five years at half of the correspondent banks in a recent survey. 3

A highly integrated branch automation system is being brought to the U.S. market by the Nixdorf Computer Corp. The system is built on integrated software that allows a single workstation to handle banking applications, office automation, data processing, and system maintenance. 6

Transfirst Corp., Dallas, said it has retained a contract to provide automated teller machine services in 200 Houston-area convenience stores that were formerly part of the 7-Eleven chain. 6

The National Automated Clearing House Association appears likely to tighten its enforcement of the "prenotification" process, a technical procedure that many financial institutions have been either disregarding or rebelling against. Despite this, a majority of bankers and others submitting comments to the Washington-based association want the controversial rule to remain in effect. 7

Twelve major computer and communications companies announced support for a set of standards, known as the Open Systems Interconnection, that make it possible to link all computers, regardless of manufacturer. 8

The Fed Reserve System posted a 9.2% increase in net income last year from the payment services it provides financial institutions. 10

Worth Repeating

Intuition says that problems in New England are going to get worse, not better. The $64,000 question is: How much worse?

James J. McDermott Jr. of Keefe, Bruyette & Woods Inc., New York. [Page 1]

Security Pacific Forced to Curb Canadian Brokerage Strategy

By JED HOROWITZ

NEW YORK — The Federal Reserve Board has quietly indicated that bank subsidiaries cannot underwrite or deal in most securities even if they immediately shift the risk to an offshore company.

The decision came to light during Security Pacific National Bank's negotiations to purchase 30% of Canadian broker Burns Fry Corp. The Fed approved the application in late April but forced the Los Angeles-based bank to give up its plan for so-called riskless principal underwriting, according to Russell Freeman, general counsel of the bank.

The Fed also ruled that the large Canadian broker must end certain real estate and equity trading activities within one year of the purchase date.

The decision was not published in the Federal Register because Security Pacific made its application under Regulation K of the International Banking Act of 1978, which does not require bulletin notices by the Fed.

Security Pacific apparently sought to permit U.S. investors to buy and sell Canadian securities through Burns Fry's U.S. brokerage subsidiary.

Under the riskless principal concept, which has been approved by the Securities and Exchange Commission, a bank-owned unit could buy or sell a se-

Security Pacific: Page 5 ➳

FROM THE REGIONS

NEW ENGLAND

Loan Quality Holding Up – So Far

By MICHAEL WEINSTEIN
New England Bureau

BOSTON — Despite investors' jitters about shaky real estate loans, asset quality at New England banks remains above the national average, except for a handful of troubled construction loans.

A survey of the biggest New England banking companies showed that nonperforming asset ratios at the end of the first quarter were stable or up modestly at most of the banks, compared to yearend 1987. "The numbers would indicate that there hasn't been a change in asset quality," said Peter J. Ostrowski of the bank and thrift consulting firm of Lyons, Zomback & Ostrowski Inc., New York.

As of yearend, almost all of the banking companies surveyed had nonperforming asset ratios that were below the national average for banks of their size. New England's banks have plunged into real estate lending, taking advantage of the region's red-hot real estate market in recent years.

But the lending bacchanalia have created fears of a wicked loan-loss hangover, according to analysts. "I know some investors who are scared," said one bank ana-

From the Regions: Page 12 ➳

Rules Will Force Japan's Banks To Raise Equity

Report Finds a Lack Of Core Capital Elements

By JOHN J. DUFFY
London Bureau

LONDON — Japanese banks may have to raise as much as $50 billion in equity in order to comply with the new international standards for capital adequacy, according to a report.

International Briefing

The report, by IBCA Banking Analysis Ltd., a London-based credit rating agency, said that while Japanese banks have ample reserves in the form of investments, they are severely lacking in so-called core capital elements such as shareholders' equity. Because of this shortfall, Japanese banks will need a big infusion of new equity before the capital proposals take full effect in 1992, the report said.

"With their low published equity-asset ratios, Japanese banks will, on the face of it, have to raise substantial equity," the report said. "At the moment, it is by no means certain just how this will be done, although Japanese banks' very substantial hidden reserves mean they clearly have ample resources."

Such hidden reserves consist largely of investments in Japanese equities, which the banks carry on their books at cost, rather than at their much higher market value. The Japanese ministry of finance has been allowing banks to include 70% of these reserves in their capital ratios. Under the new proposals, however, only 45% of such reserves will count as capital and those

Japan's Banks: Page 14 ➳

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IN THE NEWS

Reagan Has No Plan for Thrifts

WASHINGTON — A White House spokesman said President Reagan has no plan to deal with the growing thrift crisis but instead will depend on federal regulatory agencies to find ways of resolving the problem that some estimate could cost $50 billion to $60 billion to resolve.

"The regulatory authorities are in a position to deal with the problem, and we look to them for guidance," White House spokesman Marlin Fitzwater said on Tuesday when asked how Mr. Reagan intends to solve the thrifts' problems. Mr. Fitzwater said the President is being briefed on the thrift crisis by Treasury Secretary James A. Baker 3d and by Council of Economic Advisers Chairman Beryl Sprinkel.

Despite a $10.8 billion thrift bailout package Congress approved last year, which uses money from healthy thrifts to pay for closing weak ones, the Federal Savings and Loan Insurance Corp. finished 1987 twice as much in the red as at the end of 1986 — an estimated $13 billion of deficit, versus $6 billion. Thrift industry leaders say federal money will be needed to pay up to $50 billion for closing weak thrifts, which would worsen federal budget deficits.

Indian Citibank Branch Bombed

NEW DELHI — A bomb exploded on Tuesday inside a Citibank branch in New Delhi, leaving one person dead and 13 others injured, according to police and hospital officials. About 25 customers and 18 employees were inside the bank on the ground floor of a new, glass-covered 13-story building at Connaught Place, New Delhi's most prestigious shopping district, when the explosion took place.

Hundreds of police converged on the site and cordoned it off, preventing people from entering. Police bomb squad personnel searched for remains of the explosive device and also scoured Citibank offices on the third and fifth floors for other bombs.

A company official, who asked not to be identified, complained that "there is no security in the bank. The gates are not guarded. Anyone can walk in with bags that are not checked."

American Express Enters China

BEIJING — The next time Karl Malden appears in an American Express advertisement, he might be standing atop the Great Wall of China. American Express signed a deal on Tuesday with the state-owned Bank of China that gives the bank's customers access to the American Express corporate card and gold card. American Express is following a trail blazed by MasterCard and Visa, which set up their own deals with the Bank of China last year.

Hanover Signs Disaster Contract

NEW YORK — Manufacturers Hanover Trust Co. has signed a four-year contract with Comdisco Disaster Recovery Services Inc., under which Comdisco will supply the bank with custom disaster recovery services at its Carlstadt, N.J., recovery site. If service at a Manufacturers computer center is disrupted by fire or some other disaster, it has the right to use computers provided by Comdisco. Under an agreement announced by the bank on Tuesday, Comdisco will assume the majority of resources of Manufacturers Hanover Data Services Corp. Manufacturers Hanover Data Services Corp. and Comdisco have been jointly supplying disaster recovery services and facilities to the bank since 1984.

— Compiled by Dennis P. O'Connell

Half of Banks Say Check Clearing Profits Down

Survey Indicates Most of Declines Were Because of Competition from the Fed

By YVETTE D. KANTROW

NEW YORK — Half of the correspondent banks responding to a recent survey said their profit margins on check clearing services have declined over the past five years. Most of the declines were attributed to competition from the Federal Reserve System.

The survey, conducted by the Association of Reserve City Bankers, also found that two-thirds of banks providing check clearing services believe the Federal Reserve System "could eventually be the predominant provider" of these services.

The Federal Reserve has been competing with banks in the check clearing business almost since its inception in 1913. But with passage of the Monetary Control Act in 1980, the Fed has been explicitly charging fees for check collection and other payment services.

TECHNOLOGY TODAY
AN AMERICAN BANKER WEEKLY FEATURE

Section Begins on Page 6

Bankers have continually accused the central bank of using its quasigovernmental status to obtain a competitive advantage. The Association of Reserve City Bankers, which represents big city banks that compete against the Fed, late last year surveyed users and providers of check clearing services to assess the impact of the Federal Reserve's aggressive entry into the business.

The results, which were published in April, showed that many smaller banks have increased their use of Fed services since 1981, citing price reductions as the main reason.

Frederick Heldring, chairman of the association's subcommittee on Fed relations, said the study indicated that prices for Federal Reserve services have "important competitive implications for the nation's private check collection system and the ability of that private system to continue providing check collection services to the public in the future." Mr. Heldring is chairman, president, and chief executive officer of Philadelphia National Bank.

Check collection, the biggest of the payment services for which banks are

Survey: Page 9 ➡

Terry Hannum, Executive Vice President, Bank of Boulder

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May 11, 1988, American Banker

Beware of Pitfalls in Today's Leveraged Buyout Deals

The following is excerpted from remarks by Nora Ann Wallace, a member of the law firm of Willkie Farr & Gallagher, New York, presented March 31 as part of a panel discussion on loan quality at a symposium on restructuring the financial system. The symposium was sponsored by the Bank and Financial Analysts Association.

□

AS EACH WEEK goes by, the leveraged buyout market appears to get stronger and more financing becomes available. Junk bond market is coming back. Institutions are back in the market, attracted by the fact that leveraged buyouts are lower-priced and more soundly structured. And there are enormous resources in the hands of LBO funds looking for good investments.

Nonetheless, the unreliability of the junk bond market and the institutions has created new business opportunities for banks. Increasingly, banks are being called upon to provide subordinated financing in addition to their traditional secured financing, and they are able to demand higher rates, more equity contributions on the part of buyers, and equity participations for themselves.

I'd like to turn to some of the pitfalls to avoid in making LBO loans in today's environment. Some areas where I have seen problems arise are 1) in the cash flow projections on which the deal is based, 2) the total financing structure of the deal, 3) the business due diligence review performed by the lender, and 4) conflicts of interest that can arise when a lender plays more than one role in a transaction.

First, as anyone who has participated in an LBO transaction knows, the most important structuring consideration is cash flow. If a leveraged buyout does not work on a conservative projection of cash flow, it shouldn't be done. Even where a lender has a security interest in hard assets worth many times the amount of debt, practical and legal problems may prevent the lender from ever realizing on those assets.

Cautions in Evaluating Projections

So what are the things to watch out for in evaluating projections? Watch out for numbers that rely on improving revenues through synergy or growth in sales, or cutting costs by reducing overhead, working capital, or capital expenditures. The deal should work based on the company's historical numbers, adjusted only for the new financing costs and the effect of taxes.

Next, even if the sponsors of the deal have a quick exit strategy, make sure there will be enough cash available to finance the working capital and capital expenditures necessary to stay in business during the term of the loan.

Make sure that the projections take into account any contingent liabilities such as pension costs, guarantees, or litigation costs, since these do not normally appear on the balance sheet but can represent significant cash items.

Next, make sure to do a sensitivity analysis for various rates of inflation and higher interest rates. (Remember that a leveraged buyout done today, with inflation and interest rates at relatively low levels, is likely to face an increase in both.) Also factor in a possible downturn in sales that might result in a recessionary period.

Don't overlook items such as payments due on subordinated debt and ordinary operating expenses that may not be so easy to buy back if the company is to stay in business, such as payroll and rent obligations.

Finally, be extremely careful where the projections rely on selling assets or on realizing on overfundings of pension plans. These assets may not turn out to be as valuable as the buyer hopes.

The second area in which problems can arise is in the total financing structure. A large leveraged buyout financing typically has multiple layers of debt and equity, and the senior lender must take care that terms of those securities don't impair the company's financial condition.

If an investment bank or institution has made a short-term bridge loan, how is it going to be repaid? If it is intended to be refinanced with junk bonds, what if the bonds can't be sold by the time the bridge loan matures?

If subordinated debt is a zero-coupon or a pay-in-kind note, have projections taken into account the fact that they will become cash-paying at some point? Does this happen automatically or only when certain interest coverage ratios have been achieved?

Does the financing make sense in terms of the buyer's exit strategy? If the deal is an "earn-out" rather than a "bust-up," none of the debt should be structured to require large paydowns in the short term. If it is a bust-up, make sure sales are for cash and that the paydown schedule takes into account costs of sale, including taxes.

Make sure your understanding of the strategy is the same as that of the equity holders, management, and the subordinated debt holders. They will be your financial partners in this enterprise, and it is better to have an understanding up front as to the buyer's plan for the business, and to build any necessary covenants into the loan documents.

Also make sure that any existing creditors are on board, including large trade creditors. From their point of view, capital of company has been impaired, management may be different, cash management policies may change. They may not be willing to deal with the company on the same basis as before.

The third kind of pitfall to avoid is taking short-cuts in the due diligence process. Don't rely on the buyout group or subordinated lenders to do it for you. They have different economic concerns and legal rights. An independent review will also help the senior lender maintain its seniority in a bankruptcy situation.

Also, be extra careful in hostile deals, or in hostile deals that become friendly, only because management has no choice. There is little opportunity to do due diligence in these deals, and merger agreements don't have substantive reps and warranties. The company is sold on a take-it-or-leave-it basis. It's in your interest to condition the financing on having an adequate opportunity to review the company.

Finally, you should be aware of some special risks that can arise when a bank plays several roles in an leveraged buyout, by providing senior financing, subordinated financing, and taking equity.

This is a risk for the senior lender because, in a bankruptcy, it might be considered to control the borrower and be put in the legal position of a shareholder instead of a creditor. This is called equitable subordination.

> If a leveraged buyout does not work on a conservative projection of cash flow, it shouldn't be done.

There is also a risk for the bank that purchases a participation in the senior loan but doesn't get a piece of the subordinated debt or the equity. The originating bank may have a conflict between its interests as a creditor and its interest as an equity holder. If it has sold down its loan to the point where its interest as a senior lender is not as significant as its equity interest, it is less likely to call a loan or take other action that would impair the equity position.

And now I'd like to turn to the legal issue: the issue of fraudulent conveyance. A bankruptcy court can use this concept to find that a secured lender's lien on the assets of a company was a fraudulent transfer that can be voided under the bankruptcy laws. The voiding of the security interest puts the secured lender in the same position as the general creditors.

A fraudulent conveyance can be found where either there was actual intent to defraud the other creditors of the acquired company or where the facts indicate that there was constructive fraud. Since actual fraud does not usually exist in a normal commercial setting, of much more concern is the concept of "constructive fraud."

In order to establish constructive fraud, two elements must exist:

First, the court must find that the borrower did not receive fair consideration for the security interest. Second, the court must find that as a result of the transaction the borrower did not have adequate capital: because the transaction caused the borrower either to become insolvent, to be unable to pay its debts as they would mature, or to have unreasonably small capital to carry on its business.

> Hostile deals offer management no choice and little opportunity to do due diligence.

It would seem that in a leveraged buyout the borrower should receive fair consideration for the security interest, as long as the borrower receives the proceeds of the LBO loan. The problem is that the borrower immediately uses the loan proceeds to pay the selling shareholders. Recent cases have held there was not fair consideration to the borrower when the proceeds ultimately were paid to shareholders. Under this reasoning every leveraged buyout will fail the fair consideration test.

It thus is essential in structuring a leveraged buyout to satisfy the second test, the capital adequacy test. It must be shown that at the time of the leveraged buyout that the borrower was solvent, the borrower and the senior lender reasonably believed that the borrower would be able to pay its debts as they matured, and the borrower would have sufficient capital to carry on its business.

Definition of solvency for this purpose is that the "fair salable value of assets exceeds all probable liabilities." This is not a GAAP balance sheet test.

Assets for this purpose are valued not at book value but at something close to fair market value. Liabilities for this purpose must include off-balance sheet items such as guarantees and future costs of litigation.

The remaining two measures of capital adequacy — that borrower's capital was not unreasonably small and that borrower had the ability to pay debts as they mature — can be met by applying the same considerations previously mentioned that are used in evaluating projections. The company must be able to generate enough cash to pay all its mandatory obligations and maintain its operations, including generating working capital and cash necessary capital expenditures.

Whether there was a fraudulent conveyance at the time of the leveraged buyout will be determined by a court with the benefit of hindsight, maybe several years after the transaction. But the court will be deciding whether the tests were met at the time of the leveraged buyout. This means that the documentation of the transaction, the certificates and financial information delivered at closing, and the lender's due diligence files made at the time of the transaction will carry a lot of weight. Those files should include at a minimum appraisals, a solvency letter from an independent party, and detailed pro forma statements and projections.

As for the near future, the pace of leveraged buyouts should keep up in the second and third quarters. Interest rates are projected to stay low, and fears of recession have eased.

Also, this is an election year, so there is pressure to buy now in case antitrust laws or the tax climate become less favorable.

The only real threat to continued leveraged buyout activity would be a downturn in the economy.

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Survey Shows Check Clearing Profits Down for Many

➤➤ Continued from Page 3

charged by the Federal Reserve, brought in revenues of $500.6 million last year. That equaled 77% of the Fed's $649.7 million in payment service revenue, according to the central bank's annual report on payment services. The 12 Federal Reserve banks processed 17 billion checks in 1987, 4.8% more than they did in 1986.

The Association of Reserve City Bankers commissioned Kenny & Associates Inc., Memphis, to study the role pricing plays when banks choose check clearing providers. Kenny mailed a questionnaire to 3,500 banks that use check collection services and another 324 that provide these services.

Banks in the user group ranged in asset size from $25 million to $750 million, while banks in the provider group had a minimum of $750 million in assets. More than 22% of the user group and 43% of the providers participated in the survey.

30% Have Boosted Use of Fed

Nearly 30% of the 775 user banks in the survey said they had increased their usage of the Fed's check clearing services since 1981. Only 14% said they decreased Fed usage, and another 54% said they have not changed their clearing practices.

More significantly, 34% of the banks that have increased Fed usage attributed their moves to reduced per-item and deposit charges. This was even more true for larger bank respondents. Six in 10 of those with assets between $500 million and $750 million said lower prices was the primary reason for their increased patronage of the Fed.

Another 21% said they increased Fed usage because they were able to reduce their float through speedier collections.

More than half of the user banks said they expect some change to occur in their check clearing practices. Of 778 banks responding to the question, "Which of the following statements describe the future of check clearing for your bank?" 25% said they expect to use the Fed more. Other answers included greater use of correspondent banks, which garnered a 17% response, and greater use of clearing houses, at 14%.

Of 117 service-providing banks — those competing directly against the Fed — 49% said their profit margins on check clearing services decreased over the last five years. Two-thirds of those that indicated a downward trend cited increased competition from the Federal Reserve as the primary reason. Another 15% attributed the trend to increased competition from other providers, while 8% attributed it to increased operating costs.

Of the 48 provider-banks that said their check clearing profits were decreasing, 65% said they expected this trend to continue, compared to 35% who said they did not.

Check clearing profit margins increased over five years for 34% of the provider-banks. No specific reason was cited in the survey report.

The survey also asked provider banks about changes in check clearing volume since 1981. Responses were evenly divided, with 44% saying volume has increased and 44% saying it decreased. A majority of those with decreasing volumes said they expect this trend to continue.

Correspondent bankers fear the central bank's power, the survey showed. Of 138 provider banks, 66% agreed with the statement: "The possibility exists that the Federal Reserve could eventually be the predominant provider of check clearing services."

Nearly 60% agree that the Fed can charge prices too low for commercial banks to match. Forty-one percent said the number of banks offering check clearing services is decreasing.

The Association of Reserve City Bankers, based in Washington, consists of 400 senior banking executives representing 150 major banks. The check clearing survey was endorsed by the American Bankers Association. ■

Why Check Clearing Profits Are Down

Survey base: 57 bankers who say their check clearing profit margins have declined in the past five years.

Increased competition from Federal Reserve	66%
Increased competition from other providers	15%
Increased operating costs	8%
Other	11%

Source: Association of Reserve City Bankers

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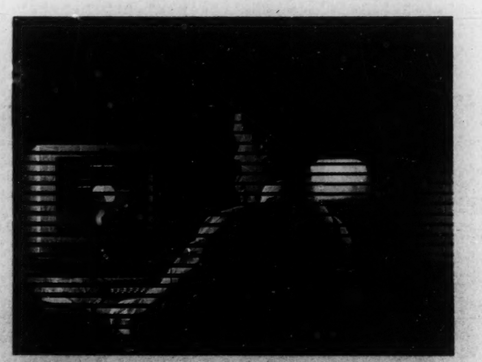

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Banker-Retailer Disputes Will Be Mooney's Topic

NEW YORK — Banker-retailer disputes, which have hindered the development of electronic funds transfer systems at the point of sale, will be the discussion topic at the May 19 luncheon meeting of the Electronic Banking Economics Society of New York.

The guest speaker will be Robert A. Mooney, president of J.C. Penney Systems Services Inc., a vendor of point-of-sale payment systems to banks and retail merchants. He is also chairman of the Electronic Funds Transfer Association, which draws members from banking, retailing, and other industries with an interest in EFT.

For information on attending, call William Herzog of the Equitable Life Assurance Society at 212-554-3979. ■

Bank Call Notice

REPORT OF CONDITION
Consolidating domestic and foreign subsidiaries of the

National Westminster Bank USA
of New York

In the state of New York, at the close of business on March 31, 1988, published in response to call made by Comptroller of the Currency, under title 12, United States Code, Section 161. Charter number: 7703 Comptroller of the Currency Second (2nd) District.

ASSETS	Dollar Amounts in Thousands
Cash and balances due from depository institutions:	
Noninterest-bearing balances and currency and coin	$ 535,327
Interest-bearing balances	607,529
Securities	1,556,097
Federal funds sold and securities purchased under agreements to resell in domestic offices of the bank and of its Edge and Agreement subsidiaries, and in IBFs	5,929
Loans and lease financing receivables:	
Loans and leases, net of unearned income 8,866,660	
LESS: Allowance for loan and lease losses 411,691	
Loans and leases, net of unearned income, allowance, and reserve	8,454,969
Assets held in trading accounts	80,619
Premises and fixed assets	238,893
Other real estate owned	4,034
Customers' liability to this bank on acceptances outstanding	256,436
Other assets	201,523
TOTAL ASSETS	$11,941,356
LIABILITIES	
Deposits:	
In domestic offices	$ 8,293,761
Noninterest-bearing 2,074,021	
Interest-bearing 6,219,740	
In foreign offices, Edge and Agreement subsidiaries, and IBFs	1,652,925
Noninterest-bearing 10,076	
Interest-bearing 1,642,849	
Federal funds purchased and securities sold under agreements to repurchase in domestic offices of the bank and of its Edge and Agreement subsidiaries, and in IBFs:	
Federal funds purchased	735,975
Securities sold under agreements to repurchase	208,363
Demand notes issued to the U.S. Treasury	169,519
Other borrowed money	53,017
Mortgage indebtedness and obligations under capitalized leases	2,605
Bank's liability on acceptances executed and outstanding	258,646
Notes and debentures subordinated to deposits	2,065
Other liabilities	130,495
TOTAL LIABILITIES	$11,507,371
EQUITY CAPITAL	
Common stock	$ 38,376
Surplus	238,657
Undivided profits and capital reserves	156,952
TOTAL EQUITY CAPITAL	$ 433,985
TOTAL LIABILITIES, LIMITED-LIFE PREFERRED STOCK, AND EQUITY CAPITAL	$11,941,356

I, Robert Call, Vice President of the above-named bank do hereby declare that this Report of Condition is true and correct to the best of my knowledge and belief.

Robert Call
April 29, 1988

We, the undersigned directors, attest to the correctness of this statement of resources and liabilities. We declare that it has been examined by us, and to the best of our knowledge and belief has been prepared in conformance with the instructions and is true and correct.

WILLIAM T. KNOWLES
ROBERT F. WALLACE
JOHN GALE
Directors

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Fed Income from Payment Services Rose 9.2% in '87

Change in Accounting Rules and a Tighter Rein on Costs Boosted Bottom Line

By JEFFREY KUTLER

NEW YORK — Controls on back-office operating costs and a fortuitous accounting change helped the Federal Reserve System post a 9.2% increase in net income last year from the payment services it provides financial institutions.

It was a big improvement over 1986, when the Fed suffered an 8.5% decline in income from what it calls priced services. Banks pay fees to the central bank for these services, which include check collections, wire transfers, automated clearing house processing.

In reversing course, the Fed managed to hold overhead to a 1.9% increase in 1987 — half the general inflation rate and well below the 6% to 8% increases in administrative costs that commercial banks have averaged in the past few years.

The Fed's costs would have risen 5.6% in 1987, closer to the banking industry norm, if there had not been a change in accounting for pension costs. Conforming to Federal Accounting Standards Board Statement No. 87, the central bank said it converted $18.7 million of pension expenses into long-term assets.

Without the accounting change, net income would have fallen by 23%.

The latest data come from the Fed's annual report on priced services, which was issued last month. It showed 1987 net income of $62.9 million on revenue of $649.7 million.

Fed Income from Priced Services

(Dollar amounts in millions)

	1987	1986	% Change
Revenue from services	$649.7	$627.7	3.5
Minus: Production expenses	506.8	497.5	1.9
Income from operations	142.9	130.3	9.7
Minus: Imputed costs	52.7	45.8	15.7
Plus: Other credits	5.0	8.0	-37.5
Income before taxes	95.2	92.4	3.0
Minus: Imputed income taxes	32.3	34.8	-7.2
Net income	62.9	57.6	9.2

Note: Priced services include large-dollar wire transfers, automated clearing house, check collections, book-entry securities transfers, float, and cash transportation. Totals in table may be off slightly due to rounding.
Source: Federal Reserve Board

Bankers Criticize Fed Reports

The Fed's priced-services reports usually are met with skepticism by executives of major correspondent banks that offer competing services. The bankers argue that the Fed, as a government agency, is not a fair or legitimate competitor. The bankers also question the cost-accounting assumptions that underlie the central bank's earnings statements.

In setting its prices and arriving at a net profit figure, the Fed calculates costs that it does not actually bear — such as taxes, deposit insurance, and interest. These figures make the Fed's bottom line theoretically comparable to that of a commercial bank.

While the accounting issues may be debatable, the growth trends are generally accepted as valid. The data-gathering methodology is consistent from year to year, making use of a Federal Reserve internal accounting system known as the Planning and Control System.

The data show the Fed has been increasing its priced-service revenue since enactment of the Monetary Control Act of 1980.

The law, which mandated the current pricing system, requires the Fed to recover its operating costs, not to make a profit. Last year it recovered 104.6% of total costs, compared with 104.2% in 1986 and 105.6% in 1985. The recovery goal for 1988 is 101.8%.

Priced services, though a major concern for the Fed's private-sector competitors, are relatively insignificant in the broader realm of central banking functions.

Services income is a fraction of the total operating income — most of it from interest on government securities — that the Federal Reserve banks earn and contribute to the Treasury each year.

In 1987, that contribution was $17.7 billion, with services income accounting for $62.9 million, or less than 4%.

Although the $62.9 million figure was up 9.2% from the previous year, the total priced-services revenue of $649.7 million was up a more modest 3.5%.

A year ago, the Fed reported that its 1986 revenue rose 2.3% to $627.7 million, but net income fell 8.5% to $57.6 million.

Back-office performance explained the difference between the 1987 and 1986 bottom lines. In 1986, these production costs rose 4.4% to $497.5 million. In 1987, they grew only 1.9% to $506.8 million.

The 1987 expenses would have been $18.7 million higher — amounting to $525.5 million and a 5.6% cost inflation — if FASB Statement No. 87 had not been invoked.

If that $18.7 million had come off of the bottom line, the after-tax net income from priced services would have fallen 23% to $44.2 million.

The imputed costs on the income statement — theoretical float, debt, sales taxes, and deposit insurance — rose 15% to $52.7 million in 1987. Income taxes, if the Fed paid those typical of the 25 largest bank holding companies, would have fallen 7.2% to $32.3 million.

The Fed said it had booked pretax profits and, hence, more than recovered its overhead costs from each of the payment services categories. They are check collection, wire transfer and net settlement, automated clearing house, securities safekeeping and non-cash collection, book-entry securities transfer, and cash services.

Check collection is the biggest business, accounting for about four-fifths of revenue and expenses. The Federal Reserve banks processed 17 billion checks in 1987, 4.8% more than in 1986.

The volume of wholesale fund transfers over Fed Wire rose 14% to $142 trillion. The average transaction amount was $2.6 million.

The Fed processed 861 million automated clearing house payments, 21% more than in 1986.

Increases in Securities' Transfers

Acting as fiscal agent for the U.S. Treasury, the Fed said it processed 7.3 million transfers of book-entry Treasury securities, up 12.3% over 1986, and 2.1 million transfers of federal agency securities, up 19.9%.

Assets on the Fed's pro forma balance sheet for priced services rose 5% in 1987 to $82.9 billion. These included $676 million of "net items in process of collection," or uncollected float, which more than doubled from $300 million at the end of 1986.

In its drive to eliminate float from the payment systems and charge banks for any remainder, the Fed recovered the cost of $756.6 million of average daily float during 1987. Only $48.2 million of average daily float went unrecovered, down from $105.6 million a year earlier. ■

US Using Automation to Collect Debts

NEW YORK — The Justice Department will use an automated system to assist in the collection of debts owed to the federal government.

The system is part of a project in which private law firms are being hired to litigate government claims against private debtors. These claims amount to $32 billion and do not include delinquent taxes.

The "privatization" of debt collection is now in a test phase, involving 10 U.S. attorneys' offices and 40 private law firms.

On April 19, Data Transformation Corp., Silver Spring, Md., won the government contract to link these offices in a computer network. It subcontracted with Legal Software Solutions Inc., Jericho, N.Y., to provide its debt collection software, known as EasyCollect.

Legal Software Solutions, formerly known as Excelsior Corp., has been developing and marketing legal and debt-collection software for the past 10 years. Last December, the City of Denver became the first government entity to buy EasyCollect, which is also being offered to banks, retailers, and other credit grantors.

The Justice Department's EasyCollect contract will yield $400,000 in software and services revenue the first year. The contract has four option years to follow. If exercised, the options could bring an additional $5.2 million to Legal Software Solutions, according to Jack Castro, president of the company. ■